COMMITTEE ON THE BUDGET

MAJORITY CAUCUS

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EARLY WARNING TALKING POINTS
ON ADMINISTRATION BUDGET PROPOSAL

MAJOR EXPANSION OF THE EARNED INCOME CREDIT [EIC]

BACKGROUND

In his State of the Union Address, the President is expected to call for a significant expansion of the Earned Income Tax Credit [EIC]. The proposal is estimated to increase the cost of this tax subsidy by $2 billion annually. This increase follows on the President's 1993 expansion of the credit, which was the largest ever, helping to nearly double the cost of the program in only 7 years, to $30 billion in fiscal year 2000.

Specifically, the President is expected to recommend four major changes to the current EIC: 1) expanding, by $500, the maximum credit/payment for filers with three or more children, bringing it to almost $4,500 regardless of taxes actually paid; 2) reducing the phaseout rate for filers with at least two children from 21 percent to 19 percent, thereby allowing filers with even higher incomes to receive the credit; 3) increasing the maximum income married couples may earn before the credit is phased out, also allowing higher income filers to now receive the credit; and, 4) exempting contributions to IRAs or 401(k) plans from income for purposes of calculating the EIC.

KEY POINTS

- It is welcome news that the White House supports tax relief for some families. But the EIC proposals help a small minority of America's working families. Only 16 percent of American families qualify for the EIC. Meanwhile, the remaining 84 percent of America's working families will receive no tax relief from this proposal.

- The Republican tax cut of 1997 provided dramatic tax benefits to lower income working families. The President's new EIC proposal has the overall effect of increasing the tax credit/income subsidy by as much as $1,150 to some of these same filers – while the vast majority of working families will receive no tax relief under the President's budget proposals.

< Rather than dipping into the surplus to fund these expansions of the EIC, the President should pay for them by simultaneously proposing reforms within the EIC to combat the current massive levels of fraud in the program. The program is rife with waste, with an estimated 21 percent of all credits claimed fraudulently. This translates to $5 billion to $8 billion every year in overpayments. (See examples below.)

< More than 86 percent of EIC benefits come in the form of direct cash payments to recipients in excess of tax payments made. Only 14 percent of EIC costs represent actual refunds of income taxes. Thus, the EIC is much more a government income subsidy than a reduction in income tax liability for most filers who qualify. Therefore, the government has reached the limits of providing a work incentive through the Earned Income Credit, and now risks turning it into a welfare program through which wealth is not created but merely redistributed.

< Reducing the income phaseout rates further perverts this program from its original goal of targeting help to the working poor. For the first time, some filers with incomes as high as $38,000 will qualify for the credit.

< The President's proposal would increase the benefits for married couples above the current phaseout rate regardless of whether they are disadvantaged by reason of their marriage under the EIC program.

< Exempting retirement savings from the EIC makes the program another Federal subsidization of retirement benefits – by replacing earned income with EIC income.

< Although the President makes these proposals in the name of increased incentives for lower income working families, they will actually make the tax code even more complicated for them, while at the same time imposing higher marginal tax rates on some of these same beneficiaries.

- The U.S. Taxpayer Advocate has said that the administration of the EIC is the third most serious problem facing taxpayers because of the complexity of the credit.

- The families on whom the EIC is targeted will face higher marginal tax rates than any other Americans. For instance, a family earning $32,000 (with three children) will have to pay 34 percent of each additional dollar of earnings in income taxes. Combined with the effect of the payroll tax, Federal marginal tax rates for this family reach more than 41 percent.

This is because the EIC credit is being phased out to zero at the same time the marginal income tax rate is climbing. Therefore, combined with State and local taxes, this could actually become a work disincentive, with a person keeping only about half of each additional dollar earned.

WASTE, FRAUD, ABUSE, AND MISMANAGEMENT

< An IRS audit of returns claiming the EIC for tax year 1994 found $4.4 billion in overpayments. A followup study by the IRS determined that, even after implementing compliance reforms designed to combat fraud, the error rate was still 21 percent of all EIC claims filed.

< The General Accounting Office [GAO] has noted: “[The EIC] has historically been vulnerable to high rates of invalid claims. During . . . 1998, of the 290,000 EIC tax returns with indications of errors or irregularities that IRS examiners reviewed, $448 million (68 percent of the $662 million claimed) was found to be invalid . . .”

< The Treasury Department Inspector General recently wrote: “The integrity of Earned Income Tax Credit payments has been a matter of concern to the IRS . . . for many years. Massive EIC scams have been identified . . . A draft IRS management study showed [an] EIC overpayment rate [of between] 32 to 34%, which translates into inappropriate payments in excess of $8 billion per year.”

< Seven inmates at the District of Columbia's Lorton Prison obtained EIC payments of $722 each by filing phony tax returns claiming income earned from jobs such as “barber” and “coal miner” when, in fact, they had been incarcerated the entire year and had no earned income.

< A Phoenix, AZ IRS examiner detected a scheme to defraud the EIC in the border town of San Luis. Although the town has only 3,500 residents, more than 13,500 tax returns were filed in 1994 claiming the town as the filer’s residence. Of those, 10,000 claimed refunds under the EIC. According to the IRS examiner: “Most of the people filing tax returns there did not qualify for the credit” since they did not even live in the U. S. They were citizens of Mexico who crossed the border to defraud the program.

For this and other information on administration budget proposals, see the House Budget Committee’s web page at www.house.gov/budget